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SUBJECT: CZECH REPUBLIC: PRIVATIZATION OF AERO VODOCHODY  
PLANNED BEFORE GENERAL ELECTIONS IN JUNE 2006

11. (U) Summary. At its cabinet meeting on July 20, the Czech government approved a privatization plan for Aero Vodochody (Aero), the aircraft company formerly partnered with Boeing until their 2003 split. Following the recommendations made by Deloitte & Touche, the government will sell Aero as a whole after a two-phase bidding process: the first round will judge the business proposals of buyers, and the second round will focus on the price offered. The privatization should be complete by the end of April 2006. To date, the Czech government has paid half of the almost CZK 11 billion (approximately \$440 million US) required to clear Aero's outstanding debt, and the other half will be paid off by the time the tender proper starts in November. Due to the current market situation, the state is unlikely to regain the money it has paid out to stabilize the company. End summary.

Money first - reward later?

12. (U) The privatization is to start this fall after the state pays for Aero's income tax arrears (250 million CZK or \$10 million US), which dates back to 1997. The tender is scheduled for the beginning of November at the earliest, when the government will pay off the remaining debt of 5.4 billion CZK (\$216 million US). This is the nominal value of bonds issued by Aero combined with the last annual interest coupon. By the end of June, the state had already paid 5.5 billion CZK (\$220 million) of this debt.

13. (U) Stabilization of Aero will ultimately cost the Czech tax payers CZK 11 billion (\$440 million) before privatization. Although the Minister of Industry and Trade, Milan Urban, hopes to find a strategic partner for Aero (such as another big player in the aircraft industry), it is unlikely that any potential owner would pay anything close to the amount already paid out of state coffers.

Ministry of Defense vs. other ministries

14. (U) The decision to privatize Aero involved an intergovernmental struggle. While representatives of the Ministries of Industry and Trade, of Finance, of Transportation and of Labor and Social Affairs supported the Deloitte recommendation, the Ministry of Defense was worried that the new owner might not ensure proper servicing and repairs of the 72 L159 aircraft that the Czech military now owns (a model for which the company has found no other buyers). The MOD produced an alternative plan to separate the repair division from the rest of the company and either fold it into the military or tack it on to a state owned company (probably to Letecke opravny Malesice, which currently repairs engines and helicopters) to ensure that the military's L159s are properly serviced. Privatization would then only affect the remainder of the company assets.

15. (U) An internal report of the Ministry of Industry leaked to the press revealed that it rejected the proposal of the Ministry of Defense on the grounds that:

- separation of a part of Aero would be technically demanding;
- the tender would be delayed by months;
- the risk would be higher that the European Commission might not approve of such a division (it could be qualified as unjustified advantage for the producer);
- the state would collect less money, while the military would to some degree still remain dependent on Aero as the L159 producer.

EC hopefully avoided in the process

16. (U) Another positive feature of Deloitte's proposal for a two-round privatization, apart from rapidity, is that the process should be relatively smooth from the point of view of the EU, as the EC would not have to be notified nor its approval sought. The only risk under the current proposal would be if conditions for the "entrepreneurial intent" in the first round were considered too restrictive in nature, and the EC were to judge it as further government support. Last year, Brussels permitted government aid of over CZK 10 billion to the bankrupt Aero but made it clear that no more similar bailouts would be appreciated.

Aero: the Phoenix rising again?

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17. (U) After parting ways with Boeing, Aero went through a year of radical changes. It significantly lowered both the number of employees and production costs. According to its annual report, it started earning profits on the Sikorski helicopter cooperative production. The company's profit in 2004 was CZK 300 million (\$12 million).

18. (U) Some bidders may be interested in Aero because it owns a private airfield which could be turned into a satellite international airport for smaller, low-cost companies. While there is no such project yet proposed, the spokesperson at the Ministry of Transportation has already made clear that it supports dynamic development of civil aviation and airport infrastructure, and the Aero spokesperson estimates that such an airport could start operating within two years if the new owner decides to go ahead with the plan.

Who wants Aero

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19. (U) Several foreign companies are said to be interested in purchasing Aero; British Aerospace and Israeli Elbit among them. Rumors have it that Russian arms companies would also be interested. At a recent lunch with Lenka Zlamalova, senior commentator for the business daily "Hospodarske Noviny," she speculated that BAE, EasyJet and McDonnell Douglas could all be interested in the sale because of the draw of establishing a satellite airport.

10. (U) Comment: The government will be careful not to repeat the unfortunate Boeing blunder and the choice of the buyer is sure to be carefully scrutinized to avoid any more costly disappointments. The latest figures showing an Aero profit are an encouraging sign, and if the sale to a strong company is carried out and a good business plan conceived, (including the establishment of a satellite airport serving budget airlines), Aero could live to see better days. A successful privatization would also gain CSSD some much-needed political points in the pre-election year and justify the government's reluctance to let Aero, with over 1,600 skilled employees, go bankrupt.

Cabaniss